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No. 92-1839

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In The

Supreme Court of the United States

October Term, 1993

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

BRIEF OF RESPONDENT

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QUESTIONS PRESENTED

1. Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant Commerce Clause, may be found by implication from congressional actions.

2. If a dormant Commerce Clause analysis were appropriate, whether worldwide combined reporting as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the foreign Commerce Clause.

3. Whether a purely prospective application should be made of any decision on the merits which concludes, contrary to this Court's existing precedent, that California's worldwide combined reporting tax method is unconstitutional as applied to a domestic-based business.

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SUPPLEMENTAL STATEMENT OF THE CASE

INTRODUCTION

Respondent Franchise Tax Board ("FTB") makes the following points in addition to those stated in Colgate-Palmolive Company's ("Colgate's") Brief.[1]

The basic question in this case is whether California's requirement of worldwide combined reporting (hereafter WWCR) may be constitutionally applied to a U.S. based multinational group. This very question was answered affirmatively by this Court in *Container Corp. of Am.* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983) (hereafter *"Container"*). In the courts below Colgate attempted to distinguish the *Container* rule on the basis that post-1983 Executive Branch statements and correspondence furnished the evidence of a clear federal directive that was missing in *Container*. This argument was rejected by the California Court of Appeal in its first decision (Pet. App. E), which found that these statements did not constitute a clear federal directive in the context of this domestic parent multinational group and that under *Container* the California method was constitutionally valid. Pet. App. E at 49a-66a. In that decision the Court of Appeal also found that Colgate's additional "competitive balance"

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[1] FTB adopts Colgate's reference of J.A. for the Joint Appendix and Pet. App. for the Appendix to Colgate's petition for certiorari to this Court. Colgate's Brief on the merits is designated as Br. CT refers to the original court file. Trial Exhibits are identified by number (for Colgate's) or letter (for FTB's), and may also include a joint exhibit reference for stipulated exhibits. Thus Ex. 37, J.E. 36 refers to Colgate's trial exhibit 37, joint exhibit 36. Frequently several joint exhibits were admitted as one trial exhibit.

issue does not arise under the foreign Commerce Clause "once voice" test (Pet. App. E at 60a) and that equal treatment of foreign-parent and domestic-parent groups was not required. Pet. App. E at 61a, fn. 10. Respondent will address these issues as well as the argument raised by Amici that *Container* was wrongly decided and should be overturned (Brief of Amici Curiae Chamber of Commerce of the United States of America, National Association of Manufacturers, and United States Council for International Business in Support of Petitioner), and the question of retrospective application of the decision in this case.

A. Colgate-Palmolive Company's Unitary Business.

In rejecting Colgate's argument that its foreign subsidiaries were autonomous and independent, the trial court found that Colgate was engaged in a unitary business, citing the following specific transfers of value: Colgate "furnished its subsidiaries with raw material, information and equipment; aided in engineering problems; developed specific accounting procedures and policies; guaranteed loans; and . . . transferred its personnel around to effect its worldwide objectives. It transferred general managers from subsidiary to subsidiary, shared in marketing experience and expertise and, to a small extent, offered its rather meager research and development knowledge to the subsidiaries." Pet. App. F, 78a-79a.

B. The separate accounting method.

Tax treaties and the Internal Revenue Code require arm's length separate accounting (hereafter AL/SA) only for national taxes. Exhibit 7, *Container*, at 196. There is no requirement that subnational taxes be imposed on the AL/SA basis. The AL/SA method fails to reflect the flow of value resulting from operational interdependencies, economic interdependencies, and functional integration between and among the parts of the worldwide unitary business. Pet. App. F at 85a-87a; *Container* at 164-5.

C. California Taxing Scheme.

WWCR is a proper and fair method of taxation which reflects a reasonable sense of how income is generated, and which avoids the basic theoretical weakness of AL/SA. *Container* at 169-70, 181, 184.

D. Opposition to California's Taxing System.

Colgate's assertion at Br. 7 that "on the domestic front, the Federal Government has pursued a policy opposing states' use of worldwide combined reporting" is without basis. In *Container* this Court noted that the "Federal Government to the degree it has spoken, seems to prefer [for its own tax law] the taxing method adopted by the international community to the taxing method adopted by California" *Id.*, 463 U.S. at 167. However, the *Container* Court did not find a policy opposing the states' use of the WWCR, and Colgate has not established the existence of such a policy.

One purpose of forming the Worldwide Unitary Taxation Working Group in 1983 after the *Container* decision was announced was to "advise and assist in the *development of a policy* dealing with the complex issues involved in the states' use of the worldwide unitary method of taxation." Ex. 37, J.E. 36. (Emphasis added.) The policy developed by the Working Group was to encourage voluntary state legislation adopting the "waters edge" principle. The President later supported federal legislation and gave instructions to the Attorney General to ensure that the United States' interests were represented in appropriate cases. J.A. 7-8. The United States has not filed an Amicus Brief or otherwise appeared in this case. Congress has not passed any legislation which restricts the power of the states to impose WWCR.

E. The Tax Assessment.

Colgate in its claims for refund contended that its worldwide operations did not constitute a unitary business. It also raised the constitutional issues of violation of the Due Process and Equal Protection Clauses by reason of taxation of extraterritorial values and violation of the Commerce Clause by reason of double taxation and impairment of the ability of the United States to speak with "one voice" in carrying out foreign policy. Colgate also contended that application of the combined reporting formula unlawfully distorted its income. Ex. 12, J.E. 7a-7d.

F. The Proceedings Below

1. Superior Court of California

Colgate's complaint raised the same issues as the claims for refund. The complaint also alleged that "there was no mutual dependence or significant contribution between the foreign subsidiaries and Colgate, and that they were in no way unitary with plaintiff." CT 4, para. 8. In discovery Colgate alleged that substantially all of its intercorporate operational documents had been destroyed and were no longer available. CT 1350-1356. The two week court trial was concerned primarily with the determination of whether Colgate's worldwide operations were unitary, and to a lesser degree the distortion issue. The foreign Commerce Clause constitutional issue was submitted on the basis of stipulated documents. In the course of the trial FTB discovered two boxes containing supposedly destroyed operational documents. CT 1943:9-1945:8.

The trial court held that Colgate's operations were unitary, finding that the evidence in favor of unitary treatment was substantially stronger than that of the taxpayer in *Container*. Pet. App. F, 80a. The trial court also relied on *Container* in finding that there was no showing of distortion. *Id.*, 81a-87a. On the foreign Commerce Clause issue, however, the trial court found the unitary method unconstitutional, holding that "it is the policy of the United States, speaking through the executive branch, that the water's edge system be followed and the unitary method discarded." *Id.*, at 91a.

2. Court of Appeal of California (First Decision)

In ruling on FTB's appeal of the trial court decision[2] the Court of Appeal rejected FTB's argument that under *Wardair Canada Inc.* v. *Florida Dep't of Rev.*, 477 U.S. 1 (1986) (hereafter "*Wardair*"), dormant Commerce Clause analysis was precluded. However, in applying dormant Commerce Clause analysis the court found that none of the statements or letters relied upon by Colgate linked domestic-parent groups to issues of foreign commerce or foreign affairs, and that they were ambiguous in the domestic-parent context.[3] The Court of Appeal stated "Because we conclude that the evidence relied upon by Colgate does not show any foreign policy implications or clear federal directives which alter the *Container* 'one voice' analysis, that analysis remains valid in the context of this case." Pet. App. E, 63a.

The Court of Appeal also noted the difference between the application of the tax to foreign-parent groups and domestic parent groups, *id.*, at 64a, and the fundamental issue of federalism presented by this case. *Id.*, at 65a. After noting that the federal executive did not act to represent federal interests in this case, the Court again concluded: "In this posture, we cannot say that California's application of the worldwide unitary tax

[2] Colgate did not appeal the trial court's decision.

[3] In its analysis of Secretary Baker's letter to Senator Packwood (Joint Appendix 13-23) the Court of Appeal noted that the policy of "competitive balance" noted in that letter is not an issue under the dormant Commerce Clause "one voice" test. Pet. App. E, at 60a.

method to domestic-parent groups with foreign subsidiaries is unconstitutional under the foreign commerce clause because it either impermissibly interferes with the conduct of foreign policy or violates a clear federal directive. In this light, *Container's* conclusion remains valid that such 'taxation is in reality of local rather than international concern.' " *Id.*, at 65a; citation omitted.

The Court of Appeal also rejected Colgate's distortion argument, in part because of the failure of Colgate's separate accounting methods to account for the flow of value between the parts of the unitary business. *Id.*, at 68a.

Finally, the Court of Appeal declined to consider Colgate's argument that foreign-parent and domestic-parent groups must be treated identically for tax purposes on the basis that the issue was not ripe for determination. *Id.*, at 66a, fn. 12. The Court also noted that the issue was not litigated meaningfully below, was not part of the trial court's decision, and was not adequately briefed. *Id.*

3. Supreme Court of California (First Petition for Review)

In its petition to the California Supreme Court, Colgate contended that a letter from Secretary Brady dated September 13, 1991, J.A. 35-47 supplied the "clear directive" that the Court of Appeal had found lacking. Colgate also urged the issues of competitive balance and equal treatment between domestic-parent and foreign-parent groups, and sought review of the distortion issue. The California Supreme Court granted the petition (Pet. App. A at 28a), but before FTB had filed its brief on the merits

it issued its *Barclays*[4] decision. The California Supreme Court ordered the case transferred back to the Court of Appeal with directions to modify its opinion in light of *Barclays*. Pet. App. C at 27a.

4. Court of Appeal of California (Second Decision)

In its second decision the Court of Appeal modified its foreign Commerce Clause analysis in accord with *Barclays* noting: "As *Barclays* explains '[i]n some cases where Congress affirmatively declines to adopt certain measures, the resulting governmental "silence" is not the sort that triggers use of a dormant foreign commerce clause analysis.' " Pet. App. B at 16a; citation omitted. The Court of Appeal found that the factors cited in *Barclays* were equally applicable to this case and held that Congress had acted to permit the tax here at issue; consequently there was no foreign Commerce Clause violation. Pet. App. B at 18a.

5. Supreme Court of California (Second Petition for Review)

On February 18, 1993, the California Supreme Court denied Colgate's petition for review of the modified opinion of the Court of Appeal. Pet. App. A at 1a.

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[4] *Barclays* refers to the companion *Barclays Bank PLC* v. *Franchise Tax Board*, No. 92-1834.

SUMMARY OF ARGUMENT

1. The California Court of Appeal has correctly applied the California Supreme Court decision in *Barclays* to this case and determined that there had been affirmative congressional action which precluded dormant Commerce Clause analysis. The arguments on this point are set forth in FTB's brief in *Barclays*, No. 92-1384, and will not be repeated here.

2. California's tax system does not violate the *Japan Line*[5] "one voice" standard which was met by this very same state income tax dealt with in *Container*. Colgate has failed to show either violation of a clear federal directive in the foreign commerce context or implication of foreign policy issues within the *Container* decision.

First, Colgate has produced no evidence of a clear federal directive in the context of this case. The California Court of Appeal carefully analyzed the presidential statement and each of the executive letters offered by Colgate and found that they did not constitute such a clear directive. Pet. App. E at 49a-62a. After oral argument in the Court of Appeal, Colgate urged the Executive Branch to file an amicus brief making explicit a federal policy against worldwide unitary taxation as applied to U.S. based multinationals.[6] J.A. 31-34. Treasury's reply was a letter which asserted "tax policy" as a basis for equal

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[5] *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), cited hereafter as "*Japan Line*".

[6] Colgate's letter reveals that Colgate perceived the court's comments at oral argument as indicating that Colgate would lose without such an amicus brief. J.A. 33.

opposition to unitary taxation of domestic-parent and foreign-parent multinationals. It is this letter that Colgate argues constitutes a "'clear federal directive' in this very case . . . " Br. 17.[7]

FTB maintains that neither this letter, nor any of the previous executive materials relied on by Colgate, is either "clear" in the foreign policy one voice context, or a directive. Further, this 1991 letter issued eight years after the *Container* decision and twenty years after the 1970-1973 years at issue is totally inapposite to this case. Colgate admits that there was no clear federal directive at the time of the *Container* decision. Colgate's Second Petition to California Supreme Court dated December 30, 1992, at 20.

Finally, the power to regulate foreign commerce is a Congressional power. Const. Art. I, § 8, cl. 3. To be cognizable under the foreign Commerce Clause, the clear federal directive must be congressional. See *Container*, 463 U.S. at 194:

> " . . . In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some

[7] FTB is at a distinct disadvantage as to these items of post-trial "evidence" produced by Colgate. FTB has no basis for objecting to the status of these letters as official actions of the Executive Branch of the United States Government subject to compulsory judicial notice under California Evidence Code Sections 452-453, but also has had no opportunity to conduct any discovery regarding the circumstances under which the letters were issued.

> explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.' (Citations omitted.)"

3. Colgate's arguments that if WWCR is found to be invalid in the foreign-parent context, it must also be invalid as applied in the domestic-parent context under considerations of "competitive balance" and "equal treatment" also must be rejected. First, these issues were not raised in Colgate's claims for refund, Ex. 12, Joint. Ex. 7a-7d, and thus are not properly before this Court to decide. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California*, 493 U.S. 378, 397-398 (1990). Further, these issues do not come under the one-voice dormant Commerce Clause analysis of *Container* (see Pet. App. E at 60a-60b), and are not within the scope of the questions stated in Colgate's petition.

Finally, Colgate has furnished no factual basis for considering these issues here. *Barclays* involves income year 1977 (franchise tax year 1978). Colgate has presented no evidence regarding the number of claims for refund pending in the foreign-parent context for the Colgate tax years 1970-1973 which are before this court. For those years, all other taxpayers will continue to be treated the same, regardless of the outcome of *Barclays*. Colgate has not shown that *Barclays* would have any significant effect on the competitive balance or equality of treatment for the Colgate years. As to all years, including years subsequent to 1977, there is insufficient basis for this Court to determine which way the competitive balance would be slanted, or to what extent, if WWCR were held to be

unconstitutional as to foreign-parent groups and valid as to domestic-parent groups for the years at issue.

Amici Chamber of Commerce, et al., erroneously rely on double taxation as a reason for overturning *Container*. If there is double taxation in the context of this case it results from the failure of AL/SA to properly allocate the income arising from the flow of value among and between the members of the unitary group. Extraterritorial value is being taxed under AL/SA, not by California.

Finally, because Colgate has presented no basis for relief for the years at issue, this Court should reserve the question of retrospective relief as to Colgate and apply any adverse decision on the constitutionality of WWCR as applied to domestic-parent groups prospectively only.

ARGUMENT

I. THE SUPREME COURT OF CALIFORNIA CORRECTLY DETERMINED THAT CONGRESSIONAL CONSENT TO THE APPLICATION OF WWCR TO MULTINATIONAL CORPORATE GROUPS PRECLUDES DORMANT COMMERCE CLAUSE ANALYSIS.

FTB adopts the argument on this issue set forth in its brief in *Barclays*, No. 92-1384.

II. AS THIS COURT HELD IN *CONTAINER*, WWCR AS APPLIED TO A U.S. BASED MULTINATIONAL GROUP DOES NOT PREVENT THE FEDERAL GOVERNMENT FROM "SPEAKING WITH ONE VOICE."

A. Introduction

In *Japan Line* this Court began developing the applicable test for determining the constitutionality of a state tax under the Commerce Clause when instrumentalities of foreign commerce are involved:

> "In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." 441 U.S. at 451.

Container refined the "one voice" test: "a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Id.*, at 194. Emphasis in original. *Container* also noted that "if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, . . . that the treatment of foreign income at the

federal level mandates identical treatment by the states.' " (Citations omitted.) *Id.*

Thus there were two prongs in the *Container* one-voice analysis: (1) whether Congress had spoken in an explicit directive mandating state taxes to follow federal practice; or (2) whether a dormant Commerce Clause analysis must conclude that the state tax prevents the Federal Government from speaking with one voice. *Container* did not consider the third alternative: whether Congress had acted to *permit* state use of WWCR as shown above.

B. There is no clear Federal directive barring California's use of WWCR.

1. A clear Federal directive, to be cognizable under the Foreign Commerce Clause, must come from Congress.

If there is either congressional action permitting state use of WWCR or an explicit directive from Congress which bars state use of WWCR, then no dormant Commerce Clause analysis is necessary. Colgate errs in placing consideration of purported "clear Federal directives" within its *dormant* Commerce Clause analysis.

Any clear Federal directive barring WWCR must emanate from Congress. This interpretation is consistent with the grant to Congress under Article I, section 8, clause 3 of the Constitution of the power to regulate commerce with foreign nations. The Congressional power in this regard is exclusive and absolute. *Buttfield* v. *Stranahan*, 192 U.S. 470, 492-493 (1904). Accordingly, only Congress has the power to take pre-emptive action. See

Container at 194: "The second of the considerations, of course, is essentially a species of pre-emption analysis" and at 197: "Thus, whether we apply the 'explicit directive' standard articulated in Mobil, or some more relaxed [dormant Commerce Clause] standard which takes into consideration our residual concern about the foreign policy implications of California's tax, we cannot conclude that the California tax issue here is *pre-empted by federal law* or fatally inconsistent with federal policy." (Emphasis added.) See also *Wardair* at 477 U.S. 6:

> "But we have consistently emphasized that the first and fundamental inquiry in any pre-emption analysis is whether Congress intended to displace state law, and where a congressional statute does not expressly declare that state law is to be pre-empted, and where there is no actual conflict between what federal law and state law prescribe, we have required that there be evidence of a congressional intent to pre-empt the specific field covered by the state law." (citations omitted)

2. The presidential statement and Executive Department letters relied on by Colgate are neither "directives" nor do they state clear opposition to WWCR as a foreign policy matter in the context of this case.

a. Executive statements, letters, or even amicus briefs are not federal directives.

First, it must be noted that the "evidence" of purported "clear Federal directives" relied upon by Colgate arose subsequent to the 1983 decision in *Container*. In fact, Colgate contends that this "policy" " . . . was explicitly

articulated in response to this Court's opinion in *Container*." Br. 37. Colgate has offered no cognizable evidence that any such "policy" existed before the *Container* decision, and certainly no evidence that it existed in the tax years 1970-73 which are before this Court. Colgate has made no attempt to bridge this chasm between the tax years at issue and the executive statements upon which it relies. California could not have been violating any 1980's "clear Federal directives" in the early 1970's.

Colgate apparently interprets *Container* to hold that an amicus brief by the Solicitor General filed in that case would have constituted a clear federal directive that would have required invalidation of the California law. Br. 34-36. Colgate is in error. The *Container* court expressly noted that lack of such a submission was not dispositive. *Id.* at 195-196. Nor would submission of such a brief have been conclusive. An amicus brief has no weight beyond the power to persuade. See Justice Blackmun's dissent in *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S.Ct. 1095, 1110 (1993). See also *Wardair*, 477 U.S. at 9-11, wherein this Court discussed the argument advanced by the United States as Amicus that there was a federal policy to exempt all air line fuel from taxation. In rejecting the U.S. argument that the Resolution of the International Civil Aviation Organization represented such a policy of the United States, this Court noted that no action had been taken to give the Resolution the force of law. *Id.* at 11. Clearly, a statement by a member of the Executive Branch that a policy exists, even in the form of an amicus brief, neither establishes that the policy exists as a matter of United States law, nor has the pre-emptive force of a directive to invalidate a state tax law.

In certain circumstances, such as the case of a presidential proclamation pursuant to a valid delegation of power by Congress, see *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936), the Executive Branch could issue a directive that would have the force of law which this Court could regard as having pre-emptive effect as to some state actions. However, none of the executive statements relied on by Colgate herein draws upon such an authority to have the force of law.

Further, the specific statement relied upon by Colgate as constituting the missing federal directive needed by Colgate in this case falls far short of carrying even the weight of an amicus brief. The statement was a reply to a letter from Colgate's Reuben Mark to Secretary Brady, J.A. 31-34, which requested that the Executive Branch "announce explicitly that the federal policy against worldwide unitary taxation applies to U.S. based multinationals. . . . We believe that the most effective means of communicating this federal policy would be the filing of an amicus brief in the Colgate case."

Rather than filing an amicus brief or otherwise intervening in the *Colgate* case, or even issuing an "explicit announcement", Secretary Brady replied by a letter to "Dear Reuben" which stated that "As a *tax policy matter*, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations." J.A. 35. (Emphasis added.) The letter and its attachments, J.A. 37-47, do not even state any foreign policy basis for the asserted opposition with respect to domestic-based corporate groups.

Secretary Brady's letter also mentions that Mr. Mark wrote similar letters to the Secretary of State, the U.S. Trade Representative, and the Acting Attorney General and that they would be making a coordinated reply. J.A. 35. Colgate has furnished no indication that any of these other officials responded.

Clearly, none of the executive departments filed an amicus brief or otherwise appeared in the *Colgate* case at Mr. Mark's request. Apparently, there was not even complete agreement among the executive departments as to the significance of this issue. In any event, Secretary Brady's letter falls far short of constituting a federal directive. It does not even attempt to direct California to conform to federal tax practices. It certainly is a woefully insufficient basis for invalidating a state law under the foreign Commerce Clause of the United States Constitution.

b. Colgate's other executive statements regarding WWCR fail to constitute federal directives.

The prior executive statements cited by Colgate at Br. 36-38 suffer the same infirmities as the Brady letter. Inasmuch as they arise from the Executive Branch, rather than Congress, they cannot constitute "clear federal directives" in the foreign Commerce Clause context. *Container*, at 194. Additionally, these statements do not have the force of law. *Wardair*, at 11. They at most represent aspirations of the Executive Branch or Treasury, not the binding policy of United States law. See *Id.*, at 10. Finally, these statements do not even clearly express, within the foreign

Commerce Clause context, opposition against WWCR as applied to domestic-based multinationals.

c. Under the dormant Commerce Clause "one voice" test, WWCR as applied to a domestic-based multinational group such as Colgate does not implicate foreign policy issues which must be left to the federal government.

1. Executive statements presented by Colgate do not establish implication of foreign policy issues which must be left to the Federal Government.

a. Documents relating to the Unitary Working group

The policy formulated as a result of the efforts of the Worldwide Unitary Working Group demonstrates a lack of "one-voice" foreign policy implications. This Court in *Container* recognized a distinction between those state taxes that merely have foreign *resonances* (and thus are valid absent an explicit directive from Congress) and those taxes which *implicate* foreign affairs (and thus may be invalid). *Id.*, at 194. This Court concluded based on the information before it that California's tax as applied to a domestic-based multinational group did not come within this second classification. Colgate wishes to change that result on the basis of the executive statements issued subsequent to the *Container* decision. FTB submits that these statements are not sufficient to meet Colgate's goals.

In fact, Colgate's evidence reveals that the purpose of the Worldwide Unitary Taxation Working Group formed

in 1983 was to "advise and assist in *development* of a policy dealing with the complex issues involved in the states' use of the worldwide unitary method of taxation." (Emphasis added) Ex. 37, J.E. 36. The Working Group developed three Principles to be used by the *states* in developing specific legislative measures:

> "Principle One: Water's edge unitary combination for both U.S. and foreign-based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." J.A. 19-20.

The *policy* adopted by the Executive Branch was to encourage the states to adopt principles one and three without federal legislative intervention. J.A. 20. On November 8, 1985, the Executive modified that policy by stating its support for the concept of federal legislation that would restrict state taxation of multinationals to water's edge combination and address the taxation of foreign source dividends. The statement also proposed amendment to double taxation agreements, enactment of domestic "spreadsheet" legislation, and instructed the Attorney General to represent the interests of the United States in appropriate cases. J.A. 7-8. The Executive Branch subsequently withdrew its support for federal water's edge legislation based on the progress of the states toward achieving these goals. J.A. 43.

FTB submits that the above only shows an executive *aspiration* to restrict state use of WWCR to the water's

edge approach. It also shows that even the Executive did not perceive the issue to be of such compelling significance that it required an immediate and uniform federal solution, but looked upon the issue as one that should be resolved voluntarily by the states through the legislative process. Finally, the Executive recognized that if the states failed to act, then the solution was to request Congressional action through legislation. J.A. 13-23. This was an implicit recognition by the Executive Branch that the power in this area did not belong to the Executive, but to Congress.

Congress, for its part, apparently did not perceive this issue as being one of interference with foreign commerce or disagree with this Court's *Container* holding. Certainly the issue and the *Container* decision were brought to the attention of Congress (see e.g., J.A. 19) but it took no action to restrict California's authority to tax nor did it otherwise express disagreement with this Court's interpretation. The failure of Congress to take action to affect the *Container* result indicates acquiescence by Congress in that decision. See *Johnson* v. *Transportation Agency*, 480 U.S. 616, at 629 n. 7 (1980), discussing the significance of Congressional inaction on a high profile issue:

> "As one scholar put it, 'When a court says to a legislature, 'You (or your predecessor) meant X,' it almost invites the legislature to answer: 'We did not'. (Citation omitted.) Any belief in the notion of dialogue between the judiciary and the legislature must acknowledge that on occasion an invitation declined is as significant as one accepted."

The actions of Congress and the Executive indicate that both of these branches agreed with this Court that California's method of WWCR did not have foreign policy implications which must be left to the federal government, but rather that, at most, WWCR raised resonances which should be treated by independent action by the states.

b. Colgate's other executive statements fail to demonstrate foreign policy implications in the context of this domestic-parent case.

Colgate's assertion that Secretary Brady's letter of September 13, 1991, and attachments, J.A. 35-47, was written on behalf of the Secretary of State and the U.S. Trade Representative is belied by the language of the letter itself. The letter states that those officials "are responding by referencing this letter." J.A. 35. Colgate has furnished no evidence that the Secretary of State, the U.S. Trade Representative or the Secretary of State did respond.

Secretary Brady's letter also does not state *foreign* policy implications of the California tax, but rather states opposition "as a *tax* policy matter . . . " citing as a basis "competitive balance." As noted above, competitive balance was an area that the Executive determined was appropriate for the states to resolve voluntarily through the legislative process, J.A. 20, an approach inconsistent with any determination that WWCR implicated foreign policy. None of the attachments to the letter, J.A. 37-49,

addresses foreign policy concerns resulting from the application of California's tax method to a domestic-parent group.

Colgate's reliance on Secretary Brady's letter of August 3, 1989, J.A. 43-44, is misplaced in this domestic-parent case. That letter references the position taken by the United States in "*amicus curiae* briefs filed in cases such as *Barclays Bank International, Ltd.* v. *Franchise Tax Board*, 3 Civ. C003388 and 3 Civ. C003389, Cal.App 3rd App. Dis." The referenced *amicus* brief expressly addresses this issue in the foreign-parent context.

Secretary Schultz' letter of January 30, 1986, J.A. 9-12, focuses on the foreign reaction to the tax. The foreign concerns addressed in the letter (foreign entry into the United States market, administrative burdens of compliance, British retaliatory legislation) arise in the foreign-parent context. See *Container*, 202-203, dissenting opinion by Justice Powell.

Secretary Baker's letter of March 5, 1986, to Senator Packwood (J.A. 13-23) also cites foreign-parent-based concerns for the administration's opposition to world-wide unitary taxation. Again, the factors cited are risk of double taxation, administrative burdens and impedance of foreign entry into the United States market. J.A. 17-19. As noted above, the primary significance of these factors is in the foreign-parent context.

Finally, Colgate's assertion at Br. 41 that Assistant Secretary Gideon's letter to Mr. Janowski, J.A. 50-51, constituted the Federal Government's "whole-hearted endorsement of Colgate's first petition for review of this case in the California Supreme Court" is an overstatement. Mr. Gideon's discussion of the petition refers only

to the *Treasury's* opposition as expressed in Mr. Brady's letter of September 13. J.A. 35-36. Both that letter and Mr. Gideon's letter refer to *tax policy*, and not foreign policy, as the basis of Treasury's opposition to WWCR. Mr. Gideon's statement that Colgate's brief makes effective use of Treasury's opposition as stated in Mr. Brady's letter does not mean that Treasury endorsed all of the arguments made by Colgate.

This letter, and all of the other letters relied upon by Colgate in this matter, demonstrate that Colgate has, since the *Container* decision, desperately urged the different departments of the Executive Branch to intervene in this matter with a clear statement, in the form of an amicus brief, that California's tax system as applied to domestic-parent groups interferes with the foreign policy of the United States. The Executive Branch has failed to file such a brief, or otherwise furnish such a clear statement. All that Colgate has been able to obtain are a few letters from Treasury asserting "tax policy" and "competitive balance" as the basis for its opposition to WWCR as applied to Colgate. The federal Executive as a whole has apparently had little interest in this case; certainly less interest than it has had in *Barclays*.

2. Colgate's "competitive balance" issue is not properly before the Court and is not part of the "one voice" dormant Commerce Clause analysis of Japan line.

Colgate's claims for refund do not raise "competitive balance" as part of the "one voice" issue. Accordingly,

this issue is not properly before this Court. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California*, 493 U.S. 378, 397-399 (1980). Additionally, Colgate has failed to establish a factual record from which this Court could determine the relative "competitive balance" if domestic based groups remained subject to the tax, and foreign-based groups were taxed under the AL/SA method, either for the years at issue or subsequently. Finally, "competitive balance" is not an area which requires federal uniformity within the purview of the foreign commerce clause.

a. The issue of "competitive balance" was not raised as a foreign Commerce Clause issue in Colgate's claims for refund and is not an issue properly before this court.

Colgate's claim for refund asserts foreign Commerce Clause issues as follows:

> "Second, because the income misapportioned to the United States members of the group is fully taxed in the foreign country where it is earned, the income is subject to double taxation in violation of the commerce clause, Article I, section 8, clause 3 of the United States Constitution. *Japan Line, Ltd.* v. *County of Los Angeles*, 441 US 434 (1979); *Western Live Stock* v. *Bureau of Revenue* 303 US 250 (1938). Finally, the inconsistency of worldwide apportionment as compared with the separate accounting, arms length method used by the United States and by foreign governments impairs the ability of the United States to speak with one voice in carrying out its foreign

policy, thereby, violating the commerce clause and the supremacy clause, Article VI, clause 2 of the United States Constitution. *Japan Line, Ltd.* v. *County of Los Angeles; Zschernig* v. *Miller*, 389 US 429 (1968)." (Ex. 12, J.E. 7a-7d, at 12-13.)

Clearly, on their face the claims for refund raise no "competitive balance" issue which would exist if only foreign-parent groups gained court relief from WWCR. The claims only address the inconsistency of worldwide apportionment (as imposed by California) with the separate accounting method used by the United States and foreign governments. The claims make no reference to actual or potential disparity of treatment between foreign-parent multinationals and domestic-parent multinationals. Nor is competitive balance between domestic-based and foreign-based multinationals a part of the one-voice analysis of this Court in *Japan Line*. FTB submits, therefore, that competitive balance was not raised in the claim for refund.

It is the settled law of the State of California that failure to exhaust administrative remedies by raising the specific issue in a timely filed claim for refund is a jurisdictional bar to pursuing that issue in court in a suit for refund of taxes. *Jimmy Swaggart Ministries* v. *Board of Equalization of the State of California, supra; A & M Records, Inc.* v. *State Board of Equalization*, 204 Cal.App.3d 358, 368 (1988). Because Colgate failed to raise competitive balance as a ground for refund in its claim, the issue is not properly before this Court.

b. "Competitive balance" is not a foreign Commerce Clause issue.

At Br. 45 Colgate charges error in the following analysis of the Court of Appeal at Pet. App. E, p. 61a:

"As we have seen, the President's statement, the two Secretary letters, and the two letters from the Justice Department attorneys show that the foreign commerce problem is essentially limited to foreign-parent groups and does not materially involve their domestic-parent counterparts. 'Competitive balance' for domestic corporations is not part of the 'foreign policy implications' issue. Therefore, the statement and letters from the executive branch officials do not constitute, either individually or collectively, an authoritative expression of the federal government that state application of the worldwide unitary tax method to domestic-parent groups with foreign subsidiaries implicates foreign policy issues which must be left to the federal government."

The Court of Appeal's analysis is supported by the treatment of competitive balance concerns by the Executive Branch. As noted previously the Executive left the resolution of this issue to the states. See J.A. 20.

Further, the "one voice" analysis arises from such concerns as foreign retaliation, *Container*, at 194, *Japan Line*, at 450, or bona fide disputes over reconciling formulae, *Japan Line*, at 450. Colgate has cited no basis for such foreign concerns predicated on domestic competitive disadvantage. In fact, not one of the executive statements relied upon by Colgate asserts this as a foreign policy issue. Rather, competitive balance is asserted to be a

matter of "tax policy". J.A. 35, 48, 50. Clearly, the implications of a competitive disadvantage to United States-based multinationals is much more a matter of domestic concern than foreign concern. See *Container*, 194-195.

3. Colgate has furnished no factual record from which this Court can determine the comparative advantages and disadvantages of the application of WWCR to domestic-based groups while foreign-based groups were to be taxed on the basis of separate accounting.

As noted by this Court in *Container*, arm's length separate accounting may in some instances result in more serious double taxation than formula apportionment. *Id.*, at 191. WWCR also may result in less tax than the use of AL/SA. *Id.* at 188, n. 25. In the instant case Colgate has furnished no factual record which establishes that AL/SA would give foreign-parent groups an appreciable competitive advantage over domestic-parent groups subject to unitary apportionment. While the playing field may be bumpy, Colgate has not shown that it will be slanted in any particular direction.

III. EVEN IF COLGATE HAD PROPERLY RAISED THE ISSUE, THERE IS NO DORMANT FOREIGN COMMERCE CLAUSE REQUIREMENT FOR EQUAL TREATMENT OF U.S.-BASED AND FOREIGN-BASED MULTINATIONAL GROUPS WITH RESPECT TO WWCR.

Initially it must be stated that this issue, like Colgate's competitive balance issue, was not raised in

Colgate's claims for refund. Ex. 12, J.E. 7a-7d. Colgate does not even attempt to bring this issue under the "one-voice" test, but rather attributes it to " . . . basic principles of Commerce Clause analysis." Br. at 45. Accordingly, this issue is clearly outside the grounds raised in the claims for refund, and not properly before this Court. *Jimmy Swaggart Ministries, Inc.* v. *Board of Equalization of the State of California, supra.*

This issue also is not within the scope of the "Questions Presented" as stated at page i of Colgate's petition for review. This issue, which alleges direct violation of the Commerce Clause, is clearly outside the purview of Colgate's first question: "Whether congressional consent to state action, which precludes judicial scrutiny of such action under the dormant commerce clause, may be found in congressional silence." Nor can this issue which Colgate asserts is "Wholly apart from Colgate's foreign policy-based contentions . . . ", Br. 45, be brought under Colgate's second question: "Whether WWCR as applied to a U.S.-based multinational group frustrates federal foreign policy, in violation of the Foreign Commerce Clause." Pursuant to Rule 14.1(a) this issue should not be considered by this Court.

Further, as is the case with the competitive balance argument, even if this Court were to hold that combined reporting was invalid as to *Barclays* for income year 1977, Colgate has presented no record from which this Court can conclude the effect, if any, of such a decision on domestic-parent multinationals for the 1970-1973 tax years at issue in this case. For these years Colgate has established no record from which an impermissible level of inequality of treatment can be determined.

Additionally, in the proceedings below, the Court of Appeal declined to rule on this issue on the basis that it was not ripe for decision, stating further that " . . . this issue was not litigated below in any meaningful fashion, was not part of the trial court's decision, and consequently has not been briefed adequately here." Pet. App. at 66a, n. 12. These factors, coupled with the lack of a factual record as noted above, strongly indicate that this Court should decline to consider this issue. See *Yee* v. *City of Escondido*, 112 S.Ct. 1522, 118 L.Ed.2d 153 at 172 (1992): "Applying our analysis . . . to the facts of a particular case without the benefit of a full record or lower court determinations is not a sensible exercise of this Court's discretion."

Finally, even if this case could present the issue as it might arise in the future – with foreign-based groups using court-imposed AL/SA and domestic-based groups using WWCR, Colgate has presented neither a factual nor a legal record sufficient to warrant review of this issue.[8] Colgate cites no factual basis for its allegation that application of WWCR only to domestic-parent groups would cause a "diminution of free competition" or cause a "resulting competitive advantage to foreign-based multinational groups like *Barclays* and its affiliates." Br. 46. As

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[8] In the real world, a decision in favor of the taxpayers in *Barclays* under a one voice dormant Commerce Clause analysis would require California to tax members of foreign-based groups as if the federal AL/SA tax law had been imposed on California, with members of the domestic groups subject to the current California choice between WWCR and water's edge approach. The domestic groups might well come out ahead in these circumstances.

noted above in connection with Colgate's competitive balance argument, there is no record of the disparity in tax from the two methods to support Colgate's unequal treatment argument.

Colgate's legal argument also fails. *Kraft General Foods, Inc.* v. *Iowa Department of Revenue and Finance*, 112 S.Ct. 2365 (1992) was concerned with a state statute which facially discriminated *against* foreign commerce in favor of domestic commerce. In *Kraft* this Court was not faced with, and did not address the issue of discrimination in favor of some participants in foreign commerce as opposed to other participants in foreign commerce. Neither did this Court hold that absolute equality of treatment was required. *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318 (1977) also involved a statute which discriminated against out-of-state sales in favor of in-state sales. It was the discrimination in favor of local commerce which was the basis of this Court's determination that the statute was unconstitutional: "We hold only that in the process of competition no state may discriminatorily tax the products manufactured or the business operations performed in any other state." *Id.*, at 337. Neither of the federal decisions cited by Colgate supports its argument on this issue.

Finally, all of the cases relied upon by Colgate involved discrimination that was imposed by the state *statutory* scheme. In the instant case, however, California's WWCR method of taxation does not discriminate between foreign-based and domestic-based internationals. The possibility of discrimination can arise only if this Court invalidates a portion of California's taxing scheme. FTB submits that it would be anomalous for this

Court to create a discriminatory scheme through a decision in *Barclays* invalidating the tax as to foreign-based groups, and then find that the resulting system was discriminatory and in effect, overrule *Container* on the basis of the question that was reserved by that Court. If the "competitive balance" policy interests have any weight in the Commerce Clause analysis, it would be against issuing any decision (in favor of foreign-based groups) which would create any such competitive imbalance.

IV. IT IS TOTALLY INCONSISTENT FOR COLGATE TO RELY ON POST 1970-73 EVENTS TO SUPPORT ITS ARGUMENT OF UNCONSTITUTIONAL INTERFERENCE WITH FOREIGN POLICY AND THEN CONTEND THAT OTHER POST 1970-73 EVENTS WHICH NEGATE COLGATE'S CLAIMS DO NOT UNDERMINE ITS CASE.

Colgate is presented with a dilemma in this case. Because of the *Container* decision, it must acknowledge that there was no clear federal directive banning WWCR and no sufficient dormant Commerce Clause one voice factors against WWCR prior to 1983. See Br. 37-38. Also, because there has been no pre-emptive change in the federal law since *Container* and because the Executive Branch has never participated directly in this case, Colgate is required to rely on post-*Container* statements from members of the Executive Branch critical of WWCR to support its foreign policy argument under the one voice element. Suddenly, Colgate is faced with a new administration that does not furnish letters supporting its position, and in fact filed an amicus brief in *Barclays* stating:

"California's recent modifications of its tax system have brought that state's law into acceptable harmony with federal and international 'arm's length' tax practice." S. Gen. *Barclays* 10. Colgate's assertion that "*existing* United States foreign policy remains unalterably opposed to state's use of worldwide unitary combination", Br. 40 (emphasis in original), is totally without factual basis.

Colgate fails to recognize that ever since *Container* the Federal Executive Branch has taken a consistent tax policy position to encourage the WWCR states voluntarily to adopt water's edge legislation such as California's current law, with full competitive balance between foreign-based groups and domestic-based groups. See Br. 11. The Solicitor General has confirmed California's successful harmonization of its law with the federal practice. None of the Executive Branch documents which have led to this successful conclusion of the political process can now have any weight in supporting Colgate's assertion of invalidity for its California taxes for income years 1970 through 1973.

V. CONTRARY TO CLAIMS OF AMICI CHAMBER OF COMMERCE, ET AL., POSSIBLE DOUBLE TAXATION RESULTING FROM THE APPLICATION OF WWCR TO MULTINATIONAL CORPORATIONS DOES NOT RESULT IN THE TAXATION OF EXTRATERRITORIAL VALUES BY CALIFORNIA.

Amici Chamber of Commerce of the United States, et al., argue that *Container* should be overruled, contending that:

"The constitutional concern that states may be taxing value beyond their borders is implicated whenever multiple taxation occurs, without regard to the mathematical niceties from which the multiple taxation arose. Amicus Br. at p. 15.

"The Constitution is indifferent to how a tax was calculated, so long as the calculation does not result in taxation of out-of-state values. *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940); cf. *Trinova Corp.* v. *Michigan Dep't of Treasury*, 111 S.Ct. 818, 831 (1991) (difference between methods of calculating tax 'is one of form and lacks constitutional significance'). One unmistakable indication of taxation of out-of-state values is that a corporation is twice taxed on precisely the same value. Whether it occurs with respect to income or property, such double taxation is unconstitutional. *Container*'s reasoning is therefore anomalous." Amicus Br. at p. 13.

Before countering this attack on *Container*, FTB notes that such an attack is completely outside the scope of the Court's review as established by the issues presented by the parties. Under Rule 14.1(a) it is not properly before the Court. See *United Parcel Service* v. *Mitchell*, 451 U.S. 56, 60, n. 2 (1981); *Bell* v. *Wolfish*, 441 U.S. 520, 532, n. 13 (1979); *Knetsch* v. *United States*, 364 U.S. 361, 370 (1970).

The error in amici's reasoning is that the fact of double taxation does not necessarily mean that the extraterritorial values are being taxed by California. As this Court noted in *Container*, "Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context

in which the double taxation takes place and the alternatives reasonably available to the taxing state." *Id.*, at p. 189.

The context of the instant case in which this issue must be examined is the comparison of the AL/SA method to the WWCR method. Double taxation will occur when WWCR taxes as California income a portion of income that is taxed under AL/SA by a foreign nation. However, extraterritorial values will be taxed by California only if that portion of income is not properly assigned to California. If that income is properly assignable to California, then the extraterritorial tax is imposed by the foreign nation under AL/SA, and not by California. Stated another way, if the differential income that is being taxed by California under WWCR as opposed to AL/SA is the income that is attributable to the failure of AL/SA to capture the "contributions to income resulting from functional integration, centralization of management, and economies of scale", *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 438 (1980), then there is no California taxation of extraterritorial value. In the context of this case, it is apparent that AL/SA is the device that more often results in extraterritorial taxation.

In *Container*, this Court made several comments which support the concept that WWCR is properly taxing transfers of value that are not captured under AL/SA. At page 181, this Court noted:

"First, appellant argues that its foreign subsidiaries are significantly more profitable that it is, and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and

sales, systematically distorts the true allocation of income between appellant and the subsidiaries. The problem with this argument is obvious: the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place. Indeed, we considered and rejected a very similar argument in *Mobil*, pointing out that whenever a unitary business exists,

> 'separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.' 445 U.S., at 438 (citation omitted)."

Id., at p. 182:

> "Appellant and its foreign subsidiaries have been determined to be a unitary business. It therefore may well be that in addition to the foreign payroll going into the production of any given corrugated container by a foreign subsidiary, there is also California payroll, as well as other California factors, contributing – albeit more indirectly – to the same production. The mere fact that this possibility is not reflected in

> appellant's accounting does not disturb the underlying premises of the formula apportionment method."

And, *id.*, at p. 183:

> "The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in *Hans Rees' Sons, Inc.*"

See also *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, ___ U.S. ___, 112 S.Ct. 2251, 2261 (1992), wherein this Court affirmed the superiority of combined reporting over geographical or transactional accounting.

Amici, in their brief sing paeans to AL/SA and to the avoidance of double taxation through the use of separate accounting, together with the mechanisms of IRC Section 482, competent authority and Advance Pricing Agreements (APA). Amici's arguments should be taken with a heaping tablespoon of salt. Initially it should be noted that most of amici's documentation is fairly recent although they advance AL/SA as a reasonable alternative to WWCR during the years in issue. The success of the administration of the arm's length method during the period here under consideration, the early seventies, is documented in the General Accounting Office (GAO) Report to the Chairman, House Committee on Ways and Means, September 30, 1981, which states:

> GAO reviewed current IRS examination data on 519 U.S. multinational corporations, each having assets over $250 million and each having

> engaged in transactions with their foreign subsidiaries. GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income for such transactions were based on a true arm's length price. *Id.* at ii.

Section 482 provides for a hierarchy of methods to be used in making these adjustments; in descending order, comparable uncontrolled transactions, resale price method, cost-plus method and, finally and least favored, any other method. The Report goes on to consider the methods used by the service in making the studied adjustments and found that 47 percent of the cases representing 86 percent of the total dollars adjusted were done by the fourth method of the hierarchy "any other method." *Id.* at 31. "Any other method" usually turns out to be a formula approach.

With respect to the current data on section 482, as of September 30, 1992, there were $14 billion in section 482 adjustments pending in the Appeals Division of the Internal Revenue Service (with an average sustain rate of 22%). GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives at 6, May 1993. The Report summarized the testimony before the Subcommittee on Oversight, House Committee on Ways and Means on the subject as follows:

> "The IRS Commissioner further testified that transfer pricing cases were inherently factual and subjective in nature. They required a great deal of cost, pricing, and market data about the taxpayer and its competitors and as a result, were extremely difficult, time-consuming, and

> costly to develop. At other times, we heard IRS officials and business representatives say that documenting and putting together a section 482 case required substantial resources from both IRS and the taxpayer involved. Both IRS and corporate taxpayers characterized the result of the adjustment process as unpredictable. *Id.* at 36.

GAO Testimony Before the U.S. Senate Committee on Governmental Affairs, Statement of Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, released on March 25, 1993, Appendix, at p. 45, notes the continuing problems with transfer pricing:

> "The challenges of section 482 cases will remain for at least two reasons. First, the growing influence of international forces on the U.S. economy will continue to increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies. This influence is demonstrated by the growing amount of merchandise exports of U.S. parent companies to their foreign affiliates, which increased from $6 billion in 1966 to $86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Second, while the new, temporary transfer pricing regulations have many promising features, they still require taxpayers and IRS examiners to collect great amounts of information and use considerable subjective judgment to compute arm's length prices."

Amici also urge the successes of competent authority in resolving double taxation issues. It should be noted that before competent authority comes into play there

must have been an audit adjustment either by the U.S. or a foreign taxing authority. The IRS report cited by amici states that competent authority's inventory averages around 250 cases (around 200 of these revolve around 482 issues). They close around 120 cases a year, of which 100 involve section 482. The tax dollars in dispute on the closed cases ranged from approximately $300 million to $540 million. As noted above, as of September 30, 1992, there were $14 billion in 482 adjustments pending in Appeals. Cases resolved by competent authority are indeed the tip of the AL/SA iceberg.[9] In this regard it also should be noted that the IRS audits slightly less than 3 percent of the universe of corporate taxpayers. June 1992, GAO Report on International Taxation, p. 32.

Clearly, the Federal government has bargained itself into what has turned out to be a costly, difficult-to-administer, unpredictable and time consuming system for allocating income among multinational businesses for national tax purposes.[10] Congress has demonstrated its

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[9] Regina Deanehan, IRS Assistant Commissioner (International) at a June 8, 1993, address before the International Fiscal Association, described "disturbing behavior" involving U.S. taxpayers who are paying additional taxes to foreign countries instead of seeking competent authority relief to resolve double taxation issues because they are wary of confronting foreign tax authorities. In such cases, the taxpayer "is asking the U.S. Treasury to underwrite [the taxpayer's] unwillingness to take on a foreign government." 2 Tax Management Transfer Pricing Report June 9, 1993, at 67.

[10] In addition to the accounting difficulties of adequately reflecting the transfers of value that occur in a multinational business, the facts of this very case are particularly illustrative of an additional reason for the inability of AL/SA to capture

unwillingness to saddle the states with the same system. FTB submits that in practice, this Court's observation in *Container* at 193, has proven to be particularly apt: "It would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." (Citation omitted.)

Finally, in addition to the complete failure of Colgate and Amici to present any valid reason for overturning *Container*, this Court has recognized that special considerations are present in cases such as this where the court is presented with issues that are within the ultimate power of Congress to resolve. In *Quill Corporation* v. *North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91, this Court was faced with a Commerce Clause issue related to North Dakota's use tax. After rejecting the North Dakota Supreme Court's conclusion that this Court's earlier decision in *National Bellas Hess, Inc.* v. *Department of Revenue of Illinois*, 386 U.S. 753 (1967), was unsound in view of later decisions, this Court stated:

> "Indeed, even if we were convinced that Bellas Hess was inconsistent with our Commerce Clause jurisprudence, 'the very fact [might] giv[e] us pause and counse[l] withholding our hand, at least for now. Congress has the

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transfers of value; Colgate denied that any such transfers took place (CT 4) and attempted to conceal the documents that evidenced the transfers, even in this litigation. CT 1937-1945, 1963-1969; FTB's Opening Brief in the Court of Appeal filed May 15, 1990, pp. 4-6. Separate accounting cannot reflect transfers of value that are concealed by the taxpayer.

power to protect interstate commerce from intolerable or even undesirable burdens.' (Citation omitted.) In this situation, it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' " (Citation omitted.) *Quill Corporation* v. *North Dakota, supra,* at 110-111.[11]

VI. IN VIEW OF THE UNIQUE FACTORS PRESENTED IN THIS CASE, THIS COURT SHOULD RESERVE THE QUESTION REGARDING RELIEF TO COLGATE, AND APPLY ANY DECISION REGARDING THE VALIDITY OF WWCR PROSPECTIVELY ONLY.

In *Harper* v. *Virginia Department of Taxation,* 509 U.S. ___, 125 L.Ed.2d 74, at 86 (1993), this Court adopted the following rule regarding retroactive application of its decisions:

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[11] See also the concurring opinion of Justice Scalia at 111-112:

> "I also agree that the Commerce Clause holding of Bellas Hess should not be overruled. Unlike the Court, however, I would not revisit the merits of that holding, but would adhere to it on the basis of stare decisis. (Citation omitted.) Congress has the final say over regulation of interstate commerce, and it can change the rule of Bellas Hess by simply saying so. We have long recognized that the doctrine of stare decisis has 'special force' where 'Congress remains free to alter what we have done.' (Citations omitted.) Moreover, the demands of the doctrine are 'at their acme . . . where reliance interests are involved.' " (Citation omitted.)

> "Beam controls this case, and we accordingly adopt a rule that fairly reflects the position of a majority of Justices in Beam: When this Court applies a rule of federal law to *the parties before it*, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." (Emphasis added.)

This Court by implication preserved the possibility of prospective rulings in those cases in which it reserved the question as to the parties now before the court. *Id.*, at 86-87, see also O'Connor dissent at 99.

A. Under Harper, Container precludes relief to Colgate in this case.

Under *Harper, Container* is controlling as to Colgate's claim for relief. The Colgate tax years 1970-73 predate the *Container* decision issued in 1983 by some ten or more years. The *Container* decision was applied by this Court to the parties before it. *Id.*, at 175, 197. Accordingly, this Court's *Container* holding that WWCR was constitutional in the face of a foreign Commerce Clause challenge is the rule of law applicable to this case under *Harper, supra,* and Colgate is not entitled to any relief.[12]

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[12] Colgate argued in its Reply Brief on its Petition for Certiorari to this Court, at 6, that FTB was contractually bound to apply relief on a retroactive basis. The paragraph of the Stipulation of Facts relied on by Colgate provides a computation only, in the event that it was determined that Colgate was entitled to a refund for the years set forth. J.A. 6. The stipulation was to facts

Additionally, the particular circumstances of this case mandate that any possible decision that WWCR is unconstitutional as applied to domestic-parent groups should not be applied to Colgate. Each of the grounds for unconstitutionality urged by Colgate arises from post 1973 events and changed circumstances arising after *Container* decision. Clearly, as this Court decided in *Container*, none of the events then considered by the Court was sufficient to constitute a violation of the foreign Commerce Clause. The events urged by Colgate to change the *Container* result (Secretary Brady's 1991 "clear directive" letter, J.A. 35, President Reagan's 1985 press statement, J.A. 7, or a "competitive imbalance" arising as a result of WWCR being found unconstitutional as to foreign-parent groups) are not circumstances that existed during the Colgate years. This case is not like *Harper* v. *Virginia Dept. of Taxation, supra*, where the unconstitutionality of the statute did not turn upon particular events but on a continuing discriminatory relationship without a time dimension. The statutes in *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803 (1989) and *Harper* v. *Virginia, supra*, were unconstitutionally discriminatory by nature and

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only. The parties expressly reserved the right to the review of *any* question of law on appeal. J.A. 4. FTB raised the prospective-retroactive relief issue at the earliest next California procedural opportunity after this Court's decision in *James B. Beam Distilling Co.* v. *Georgia*, 501 U.S. ___, 115 L.Ed.2d 481 (1991), which indicated that if relief is given to the first taxpayer to raise a Constitutional issue, some form of retrospective relief must be given to all taxpayers who have perfected their claims.

operation, regardless of any time period or other independent factors. There was no particular event or series of events that brought about unconstitutionality.

Further, in *Harper, supra,* and *Davis, supra,* the discriminatory operation of the statutes was constant as to the groups of taxpayers involved. All Federal retirement earnings were taxed, all state retirement earnings were exempt. It was not a case such as this where some taxpayers will pay more and some will pay less under either method of taxation.

In this dormant Commerce Clause aspect of Colgate's argument, however, we are presented with a form of constitutionality that is not constant. Rather, Colgate urges what may be best termed a species of "transient" unconstitutionality, an unconstitutionality that arises, if at all, from the interaction of WWCR with independent events that exist within a particular time frame. For instance, if WWCR were to be declared invalid as a result of interference with foreign policy, there must be a foreign policy with which that interference occurs. If that policy has not come into being (see *Wardair* at 10-11 differentiating between aspirations and policy) or has ceased to exist (i.e., if the Federal Government were to enact a policy to adopt WWCR both at the national and subnational levels), then the interference would not exist. Likewise, if the alleged unconstitutionality stems from violation of a clear federal directive, then it is only after that directive has been promulgated and while it has preemptive effect that unconstitutionality exists. If the alleged invalidity is based on competitive imbalance or unequal treatment arising from 1994 court determinations involving foreign-based multinational businesses, it is

only while there is competitive imbalance or disparate treatment at a level which contravenes an existing policy that unconstitutionality occurs. This sort of "transient" unconstitutionality has a time and event factor not present in *Harper* v. *Virginia Dept. of Taxation, supra*. Because there has been no showing by Colgate that any of these events existed at all, much less in the relevant time period, Colgate should be denied relief and the question of retrospective operation should be reserved.

Finally, the fact that this case involves an issue arising under the Commerce Clause presents particular considerations that militate against overturning *Container*, even if this Court has some reservations concerning its viability under changed conditions. As noted by Justice Scalia in his concurring opinion in *Quill Corporation* v. *North Dakota, supra*, at 111-112:

> "We have long recognized that the doctrine of stare decisis has 'special force' where 'Congress remains free to alter what we have done'. (Citations omitted.) Moreover, the demands of the doctrine are 'at their acme . . . where reliance interests are involved.' " (Citations omitted.)

B. If this Court were to hold WWCR invalid on foreign Commerce Clause grounds, any relief should be prospective only.

In *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971) this Court established the criteria for determining when a decision should not follow the normal rule of retroactive application, but should be applied prospectively only:

> "First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Second, . . . we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation. Finally, we [must] weig[h] the inequity imposed by retroactive application, for where a decision of this Court could produce substantial inequitable results if applied retroactively there is ample basis in our cases for avoiding the injustice or hardship by a holding of nonretroactivity." 404 U.S. at 106-107, (citations and internal quotations omitted), as quoted in *American Trucking Associations Inc.* v. *Smith*, 496 U.S. 167, 179 (1990).

Application of these criteria to this case makes it clear that any decision of this Court invalidating WWCR as applied to this taxpayer should be given prospective application only. Any such decision would meet the first element of the test in that it would overrule this Court's clear precedent upholding the constitutionality of this very tax in *Container*. With respect to the second element, the changes in California law cited at Br. 5, n. 4[13] have largely removed the continuing effects of any decision in this case. Certainly, there is absolutely no basis for any

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[13] FTB contests Colgate's assertion that the modification to California's WWCR was "in response to widespread opposition." The legislative changes culminated a political process involving many considerations.

foreign concern over California's method of taxation under the new law as applied to domestic-based groups. The matters addressed at p. 2a, App. A to Colgate's Supplemental Brief on Petition for a Writ of Certiorari refer only to the *Barclays* position. Certainly, prospective application of any decision would serve to quell any continuing concerns. With regard to the third element, the reliance interests are evident. As noted at Br. 38, approximately $1.2 billion in refund claims and $1.9 billion in assessments rest on the outcome of this case alone. The fiscal impact on the state of an adverse decision applied retrospectively would be devastating. Finally and most importantly, both California and taxpayers have relied on *Container* as affirming the validity of WWCR for the more than ten years after that decision, as well as for open years at the time *Container* was decided. For most of that period FTB is now precluded from assessing additional tax as to those taxpayers who reported under WWCR and would have owed more under AL/SA.[14] There are also taxpayers who would have owed less under AL/SA but have filed no refund claims in reliance on *Container*.

It should be further noted that Colgate's allegations of Commerce Clause infirmity in WWCR, if they existed at all, would arise from the potential conflict in our federal system of government between the power of the states to tax and the power of the federal government to conduct foreign affairs, Pet. App. A, 65a, rather than from

[14] The usual Statute of Limitations for assessment of deficiencies is four years under Revenue and Taxation Code Section 25663.

an unfairness or denial of due process in application of the tax to domestic-parent groups. This case does not present the same equities for retroactive relief as would a tax unfairly and discriminatorily extracted from all members of a defined group.

CONCLUSION

Colgate loses this case whether this Court upholds the *Wardair* analysis employed by the California Supreme Court in *Barclays*, or the dormant Commerce Clause analysis of *Container*. Under the *Wardair-Barclays* analysis, Congress has acted to allow WWCR, and Colgate's post-*Container* executive statements are irrelevant. Under the dormant Commerce Clause Test of *Container*, Colgate has failed to show either violation of a clear federal directive, or that any foreign policy has been interfered with in the domestic-parent context at any time. Moreover, Colgate has failed to show that the statements it relies on are related to the tax years 1970-73 at issue.

FTB respectfully requests that this Court affirm the decision of the California Court of Appeal. Alternatively, FTB requests that any decision which impinges on the constitutionality of WWCR as upheld in *Container* reserve the question as to relief to Colgate and be applied prospectively only.

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Respectfully submitted,

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